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Sponsors take closer look at emergency savings options

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The pandemic drove the need for having emergency savings, says Alex Moen, regional retirement plan consultant with Francis Investment Counsel.

Legislation would allow participants to withdraw from retirement accounts

For plan sponsors, nothing is off the table when it comes to solving a problem that the pandemic pushed to the fore: the lack of emergency savings among low- and middle-income Americans.

Plan sponsors are not only backing proposed legislation that would allow participants to withdraw up to $1,000 in emergency funds from their retirement accounts. They're also evaluating what types of emergency savings vehicles to offer their employees, considering both "in-plan" and "out-of-plan" savings options. Many are even considering reinstating long-discarded plan provisions that would make in-plan savings possible.

"The pandemic really drove home the need for having emergency savings, whether it be in a bank, within the retirement plan or within other qualified savings options," said Alexandra Moen, a regional retirement plan consultant with Francis Investment Counsel LLC in Minneapolis.

Many plan sponsors see an easy fix in proposed emergency savings legislation introduced by Sen. James Lankford, R-Okla., and Sen. Michael Bennet, D-Colo., on May 27. The bill — called the Enhancing Emergency and Retirement Savings Act of 2021 — would allow participants to withdraw up to $1,000 from their retirement savings accounts for emergencies such as unexpected roof repairs, without having to pay the 10% early withdrawal penalty if under the age of 59½. They would be allowed to draw only from vested amounts over $1,000. "The idea is that individuals should have a base of retirement savings — that is, $1,000 — before they should be able to make emergency withdrawals," said Kent Mason, a partner at Davis & Harman LLP in Washington.

Participants would be permitted to take one emergency distribution annually provided they replenish any prior emergency funds they withdrew, Mr. Mason said.

Plan sponsor trade groups widely support the measure, saying greater access to retirement savings for emergencies would persuade more people to participate in retirement plans.

“Allowing participants access to savings for emergencies will encourage participation in retirement programs — particularly for those who may be hesitant to 'lock away' money in case they will need it later," Aliya Robinson, senior vice president of retirement and compensation policy at The ERISA Industry Committee in Washington, wrote in a letter to Messrs. Lankford and Bennet.

Lynn Dudley, senior vice president of global retirement and compensation policy at the American Benefits Council in Washington, shared similar views. "Even relatively small, unexpected expenses, such as a car repair or a modest medical bill, can be a hardship for many workers and fear of those expenses can keep them from saving," she wrote in a letter to the senators.

Alicia Munnell, director of the Center for Retirement Research at Boston College, doesn't see much harm in the bill, saying $1,000 is "so little money that it makes it not troublesome." In fact, the emergency withdrawals proposed in the bill "might be an easier, more direct way of getting at the problem" than emergency sidecar accounts, which are very cumbersome to set up, she said.

Not everyone, though, likes the bill. Robyn Credico, Willis Towers Watson PLC's Las Vegas-based defined contribution consulting leader, fears that participants would not return the money they withdrew from their retirement accounts for emergencies.

"It's not likely that people will put the money back or make it up," she said of the proposed emergency withdrawal measure, which allows participants to recontribute what they withdrew within three years.

Instead, Ms. Credico favors the use of emergency savings accounts. "I'd rather see employers help people save in a rainy day fund than take money out of their retirement plan because I don't think people will pay it back," she said.

While there are no known official surveys on the number of plans offering emergency savings options, industry observers say the number is negligible. None of Willis Towers Watson's plan sponsors clients offer emergency savings accounts, except "maybe one," Ms. Credico said.

Francis Investment Counsel's Ms. Moen also reports relatively few plan sponsors offering emergency savings programs but says that many are thinking about putting them in place. "I know that there are a number of employers that are currently evaluating implementing a program in some form," she said.

Dual strategies

Plan sponsors have two ways in which they can help employees set up an emergency savings fund: they can establish a savings mechanism as part of the retirement plan, or they can set it up separately. An in-plan emergency savings fund is typically financed with what's referred to as "traditional after-tax contributions," which are not to be confused with Roth after-tax contributions. Participants would in effect make after-tax contributions to their emergency savings funds after making either pre-tax or Roth after-tax contributions to their retirement accounts.

"It acts almost like a mini bank account or savings account within your larger 401(k) plan," Ms. Moen said.

After-tax contributions for emergencies are typically invested in money market or stable value funds offered within the plan, she added.

Traditional after-tax contributions, which predate Roth after-tax contributions, were common in plans in the past but fell out of use, according to Ms. Moen. Over time, plan sponsors removed the option from their plans and are now looking to reinstate it to facilitate emergency savings.

"It is a little bit we're coming full circle in terms of plan design," Ms. Moen said.

Probably the biggest advantage of an in-plan emergency savings option is that plan sponsors can continue working with their current plan providers. "It might be a little bit easier upfront to implement because you're working with your current record keeper or maybe just expanding the payroll file," Ms. Moen said.

An in-plan option, however, requires a strong employee education and communication program to support it. "It's really on the plan sponsor and/or consultant or providers working with the company to drive the education around how this will work," Ms. Moen said, adding that participants would otherwise not utilize the emergency savings option.

An even greater disadvantage is that the emergency savings after-tax contributions will impact a plan sponsor's discrimination testing. Unlike pre-tax and Roth contributions, which are subject to average deferral percentage testing, after-tax contributions are subject to average contribution percentage testing, a fact that throws many plan sponsors off.

"You do want to do your homework on the front end in terms of the fiddle work with your required compliance testing annually," Ms. Moen said.

‘New frontier'

To avoid the issue of discrimination testing, plan sponsors may opt for an out-of-plan emergency savings program with an outside vendor via their record keeper, an arrangement that Ms. Moen describes as "the new frontier" in emergency savings. While a stand-alone program, separate from the 401(k) plan, would be more cumbersome to set up and require separate payroll files and employee logins, it would not have the "dark cloud" of discrimination testing "hanging over it," Ms. Moen said.

Stand-alone programs, however, are in their infancy, with plan sponsors waiting for record keepers to roll them out, Ms. Moen said. So far, only a handful of plan sponsors have implemented outside emergency savings programs because record keepers have not yet built the "solution" or partnership, she added.

Once record keepers start rolling out programs in the third or fourth quarter as they indicated to her this spring, Ms. Moen anticipates an uptick in the number of plan sponsors making out-of-plan savings options available.

"We probably will see much more uptake in that as an option going forward as a lot more of these solutions are rolled out," she said.

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